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No. 64

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NIAGARA FALLS BREWING COMPANY, AND PAUL A. SCHOELLKOPF, CHAS. E. HAEBERLE, FRED H. KRULL, EDSON P. PFOHL, ALBERT T. MAYLE, FREDERICK CHORMANN, RUDOLF V. ROSE, AND GEORGE F. NYE, AS DIRECTORS OF SAID COMPANY AND TRUSTEES THEREOF IN DISSOLUTION.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Attorney General on behalf of the Commissioner of Internal Revenue prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above cause on December 16, 1929, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

This case reached the Circuit Court of Appeals on the petition of respondents, Niagara Falls Brewing Company, et al., for a review of the decision of the Board of Tax Appeals determining deficiencies in respondents' income and profits taxes for the years 1918 and 1919 in the respective amounts of $18,561.17 and $5,013.65. (R. 71.)

The material facts are not in dispute and may be briefly stated as follows (R. 47–58):

Prior to national prohibition, the taxpayer was engaged in manufacturing and selling beer. Its business and good will were created by such manufacture and sale. At the time of its organization in 1902, the taxpayer acquired the buildings and equipment of a predecessor brewing company and thereafter it constructed new buildings and installed additional machinery and equipment which were specially constructed and designed for the manufacture of beer and were not available or readily adaptable for other uses. In 1917 the taxpayer began the manufacture and sale of dealcoholized beer, known as "near beer," in the production of which the same machinery and the same processes were used as were employed in making alcoholic beer. In 1919 the manufacture and sale of beer was discontinued and entirely abandoned because of national prohibition, but "near beer" was thereafter produced and sold by the taxpayer in order to see if the plant could be profitably operated. Sales of this beverage, however, declined after the effective

date of the Eighteenth Amendment, although the taxpayer did not lessen to any degree its efforts to make sales of the product.

The taxpayer, upon abandonment of the manufacture and sale of beer in 1919, considered adapting its plant to other manufacturing and commercial purposes, but no other use could be found for the plant because the construction and condition of the buildings and machinery rendered them unsuitable for and not readily adaptable to other uses, and the best offer obtainable by the taxpayer for the purchase of the property was $35,000 in cash made by the owner of adjoining premises. When the sale of beer was discontinued in October, 1919, the taxpayer abandoned the lower floor of one of its buildings which had been devoted to storing and aging beer. Thereafter one-half of another building, with the equipment therein, which had been used three or four times a week in manufacturing beer was used only about once every two weeks in making "near beer." In December, 1921, the taxpayer dissolved as a corporation because of its inability to operate the business at a profit after prohibition and in January, 1922, the plant was leased for three months, renewable at the option of the lessee, at an annual rental of $5,000 p[illegible] taxes, insurance, and repairs, which was the highest rental offered at any time.

The depreciated cost of the buildings, machinery, and equipment used in the manufacture of beer was $300,968.86 on March 1, 1913, and $377,054.60 on

December 31, 1917. These amounts also represented the fair values of the properties on the same dates. The net depreciated book cost of the same properties at December 31, 1918, was $193,918.95 and at December 31, 1919, was $129,814.16. The value of the machinery in 1918 and 1919 after prohibition became reasonably certain was not in excess of $10,475, while the value of the buildings at the same time was about $34,000.

The taxpayer charged against its earnings and deducted on its income-tax returns the sum of $110,047.52 in 1918 and the sum of $57,139.99 in 1919 for obsolescence of its buildings, machinery, and equipment used in the manufacture and sale of beer. These amounts so deducted represented the charges considered necessary to bring the assets down to an amount realizable upon a forced or liquidation sale after prohibition, and were determined upon consideration of what similar property could be and had been sold for and in the light of the fact that the brewing of beer had been necessarily curtailed more than theretofore, and the further fact that no market was available for the sale of machinery and equipment of that kind. The value of all the property used in the manufacture and sale of beer at the end of 1918 and 1919 was less than its depreciated cost or book value after deducting the amounts charged off for obsolescence of such property during those years. The difference between the value in 1918 and 1919 and the depreciated cost of the petitioner's ma-

chinery and buildings at December 31, 1917, was due to the imminence and incidence of war-time and permanent prohibition legislation.

The Commissioner disallowed the deductions claimed for obsolescence on the ground that the taxpayer continued in a similar or related business after prohibition. (R. 32.) The Board of Tax Appeals sustained the Commissioner and held that no deduction for obsolescence may be allowed where the assets were useful for other purposes and were used therefor after prohibition became effective. (R. 60.) The Circuit Court of Appeals, relying upon its decision in *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F. (2d) 219, held that, upon the conceded facts, the amounts claimed for obsolescence were justified and should have been allowed, and accordingly reversed the Board.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

I. In holding that where tangible assets of a taxpayer decline in value as a result of the extinguishment of its business by prohibition legislation the taxpayer may deduct from income any amount as obsolescence of such assets under Section 234 (a) (7) of the Revenue Act of 1918.

II. In holding that under the facts the taxpayer was entitled to deduct for the years 1918 and 1919 any amount for obsolescence of tangible property employed in its business.

REASONS FOR GRANTING THE WRIT

1. The decision in the present case is in conflict with and contrary to the decisions of this Court.

In *Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384, this Court denied the taxpayer the right to deduct any amount from income under the provisions of Section 234 (a) (7) of the Revenue Act of 1918 for obsolescence of its good will during the time when it had become certain that such good will would be destroyed by prohibition legislation. This Court denied the deduction claimed on the ground that when a business is extinguished as noxious under the Constitution the owners can not demand compensation from the Government, or a partial compensation in the form of an abatement of taxes otherwise due, and that Congress could not have intended such partial compensation to be provided for by the words "exhaustion" or "obsolescence." This reasoning is equally applicable to a claim for deduction on account of obsolescence of tangible property of a brewing business proscribed by national prohibition.

In *Renziehausen* v. *Lucas*, 280 U. S. 387, the taxpayer claimed the right to deductions from income during the years 1918, 1919, and 1920 on account of obsolescence of good will and tangible property of a distilling business resulting from prohibition legislation. The claim was denied on the basis of the decision in the *Haberle Brewing Co. case*, and because of the additional fact that the taxpayer continued to manufacture whiskey for medicinal

purposes after national prohibition became effective and until the enactment of the Willis-Campbell Act of November 23, 1921, c. 134, 42 Stat. 222. In the instant case the taxpayer continued to use its plant and equipment in manufacturing near beer after national prohibition became effective.

2. The question is of present importance in administering the tax laws, since it is involved in cases now pending in the courts, the Board of Tax Appeals, and the Bureau of Internal Revenue. Without a decision of this Court, the Commissioner of Internal Revenue is unable to determine the proper principle to be applied in such cases, and an acceptance of the decision in this case would leave the matter in confusion. Although the Commissioner believes that the basis of this Court's decisions in the *Haberle Brewing Co.* and *Renziehausen cases* is equally applicable to the instant case, the confusion results from the fact that in the cited cases the discussion was confined to deductions for obsolescence of good will.

Wherefore, it is respectfully submitted that the petition should be granted.

WILLIAM D. MITCHELL,
Attorney General.

MARCH, 1930.

BRIEF IN SUPPORT OF PETITION

OPINION BELOW

The opinion of the Circuit Court of Appeals is not reported.

The findings of fact and opinion of the Board of Tax Appeals (R. 46–61) are reported in 13 B. T. A. 1040.

JURISDICTION

The order of the Circuit Court of Appeals reversing the decision of the Board of Tax Appeals was entered on December 16, 1929.

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Where the imminence of prohibition legislation which will extinguish a taxpayer's business causes the tangible property employed in the business to decline in value, may the loss in value be deducted from income as obsolescence under Section 234 (a) (7) of the Revenue Act of 1918?

2. If deductions for obsolescence of tangible property resulting from prohibition legislation are allowable, is the taxpayer entitled to such deductions where it continued to use the property in the manufacture of near beer after national prohibition became effective?

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1078, provides in part:

SEC. 234(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence; * * *.

STATEMENT

A statement of the facts and of the errors relied upon will be found in the petition.

ARGUMENT

The Circuit Court of Appeals held that obsolescence occurs, resulting in a state more obsolete, when the property is less used or more neglected without forthwith rendering it entirely obsolete, and allowed as a deduction in computing net income the loss due to diminution in value of the property, resulting from the abolition of the business by prohibition legislation, during the period between the date such legislation became certain and the date when it went into effect. The Circuit Court of Appeals, as authority for this holding, relied upon its decision in *Haberle Crystal Springs Brewing Co.* v. *Clarke,* 30 F. (2d) 219, wherein it said (p. 220):

> A brewery may fairly be regarded as obsolete after prohibition, and as subject to obsolescence during the period between the date when such legislation became certain and the date when it went into effect.

Since the decision in the instant case this Court has reviewed on certiorari and reversed the decision of the Circuit Court of Appeals in the *Haberle Brewing Co. case* (*Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384). In holding that the taxpayer was not entitled to deduct any amount from income under the provisions of Section 234 (a) (7) of the Revenue Act of 1918 for obsolescence of its good will by reason of impending prohibition legislation, this Court said (pp. 386–387):

> In our opinion the words now used can not be extended to cover the loss in this case and it is needless to speculate as to what other cases it might include. It seems to us plain without help from *Mugler* v. *Kansas*, 123 U. S. 623, that when a business is extinguished as noxious under the Constitution the owners can not demand compensation from the Government, or a partial compensation in the form of an abatement of taxes otherwise due. It seems to us no less plain that Congress can not be taken to have intended such a partial compensation to be provided for by the words "exhaustion" or "obsolescence." Neither word is apt to describe termination by law as an evil of a business otherwise flourishing, and neither becomes more applicable because the death is lingering rather than instantaneous. It is incredible that Congress by an Act approved on February 24, 1919, should have meant to enable parties to cut down their taxes on such grounds because of an amend-

ment to the Constitution that it had submitted to the legislatures of the States in 1917 and that had been ratified by the legislatures of a sufficient number of States the month before the present Act was passed.

Although the Court there dealt specifically with intangible property, the principle upon which the decision is based, namely, that Congress did not intend to allow an abatement of taxes through obsolescence deductions where the business had been extinguished by statute as noxious under the Constitution, would seem to be equally applicable to tangible property. It is submitted that the opinion of this Court in the *Haberle Brewing Co. case* is controlling herein and that no deductions from gross income representing losses or obsolescence of tangible or intangible property arising from or consequentially following upon the enactment of national prohibition are allowable.

Even if such deductions are proper with respect to tangible property, the taxpayer in the instant case did not establish its right to deductions before the Board of Tax Appeals. "Obsolescence" is the state of becoming obsolete and refers to a situation where the commercial usefulness of an asset will terminate before the end of its physical life. From its very nature, therefore, obsolescence begins only when from the existing facts the taxpayer has substantial reason to believe that the usefulness of the assets in his own or in any other business will end at some fairly definite time in the future when they

must be abandoned before the expiration of their normal physical life. This was not the situation of the taxpayer and the evidence supports the view that its tangible assets were not in a process of obsolescence during the years 1918 and 1919. The record shows that in 1917 the taxpayer began the manufacture of near beer, using the same machinery and equipment as that which it had used in manufacturing alcoholic beer. (R. 54, 58.) The machinery and equipment was continued in use for this purpose after prohibition legislation became effective. Its commercial usefulnes was not destroyed by such legislation and there was no basis for an obsolescence deduction.

In *Renziehausen* v. *Lucas,* 280 U. S. 387, the taxpayer claimed the right to deductions from income during the years 1918, 1919, and 1920 on account of obsolescence of good will and tangible property of a distilling business, resulting from prohibition legislation. The claim was denied on the basis of the decision in the *Haberle Brewing Co. case,* and because of the additional fact that the taxpayer continued to manufacture whiskey for medicinal purposes after national prohibition became effective and until the enactment of the Willis-Campbell Act on November 23, 1921, c. 134, 42 Stat. 222. The situation of the taxpayer in the instant case was similar to that of the taxpayer in the *Renziehausen case.*

It is submitted that the decision of the Circuit Court of Appeals is in conflict with the principles

upon which the above decisions of this Court were based, but that in view of the fact that the discussions in those decisions were confined to intangible assets the proper course to be followed by the Commissioner in disposing of pending cases involving tangible assets is left in doubt unless this Court will review the decision of the Circuit Court of Appeals.

CONCLUSION

In order that there may be a conclusive determination of this question involving a principle of statutory construction of present importance in administering the income tax laws, it is urged that this Court grant the petition.

Respectfully submitted.

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